IPAMS
Independent Petroleum Association of Mountain States

620 Denver Club Building ◆ 518 17th Street ◆ Denver, Colorado 80202-4167 ◆ 303/623-0987 ◆ FAX: 303/893-0709 ◆ E-mail: ipams@netway.net

July 23, 1998

Mr. David S. Guzy
Chief, Rules and Publications Staff
Royalty Management Program
Minerals Management Service
P. O. Box 25165, MS 3021
Denver, CO 80225-0165

RE: Establishing Oil Value for Royalty Due on Federal Leases;
Further supplementary proposed rule
63 FR 38355, July 16, 1998

Dear Mr. Guzy:

The Independent Petroleum Association of Mountain States (IPAMS) is pleased to comment on the Minerals Management Service's further supplementary proposed rule referenced above.

We are curious why MMS chose to reopen the comment period on July 8 for sixteen days and then publish the further supplementary proposed rule within that time frame, on July 16, leaving only eight days in which to submit comments on the further supplementary proposed rule. The foreshortened time period provided for submitting comments on the supplementary proposed rule may prove difficult for some to meet, given the conflicts during the week the comments are due – for example, the Rocky Mountain Mineral Law Institute July 23-25 – as well as the rather unexpected nature of the proposal.

IPAMS is concerned with MMS's movement on these issues. While these modifications represent a beginning, there is still a long way to go in resolving the issues that remain with the proposed rule. In no way do these modifications address the many other concerns IPAMS has with the

proposed oil valuation rule. In fact, IPAMS still believes MMS is ignoring our comments on the most critical issues. Much remains to be done in order to develop a rule that results in an accurate and fair market value of crude oil at the lease without creating a nightmare of costly administrative burdens for both government and industry.

Definition of "affiliate"

IPAMS is pleased MMS is now proposing to retain the current meaning of affiliate that is contained in the existing definition of an arm's-length contract. We believe the addition of a separate definition of affiliate, along with the definition of arm's-length, will indeed provide further clarity. Most importantly, this change will appropriately enable many more lessees to pay on their gross proceeds that, under the second supplementary proposed rule, would have had to value their crude oil under non-arm's-length benchmarks or NYMEX.

However, an important policy issue is still a great concern to IPAMS members. There are instances where leases may be situated in remote locations and several small independent companies will join together to build a captive gathering system for the purpose of moving their production to a central gathering system or market point. If one of the parties happens to own 10 percent or more of that system, under MMS's definition, an affiliate situation exists.

If any of the parties sells production to the company that owns 10 percent or more, they would be required to value their production as if it were sold non-arm's-length – even though the two companies may otherwise have opposing interests. (We acknowledge that this is currently more common in the gas arena than the oil arena, but the concept is the same, and IPAMS believes all MMS's regulations must be as consistent as possible with respect to these types of general policy issues.)

Even more ambiguous is the problem that if a lessee sells production to another party in the system, he may not deduct the costs of moving his production on the system; however, if his production is sold to a third party, he is permitted to deduct the costs. The inconsistency of this policy makes no sense.

IPAMS again urges MMS to retain lease based benchmarks that are derived from comparable sales in the same field or area to value production, and to quit pursuing prices based on sales that occur at some downstream point. That is the only way MMS can expect to arrive at an accurate and fair market value for production from a specific field or area.

Breach of duty to market

While IPAMS believes it is important to state in the regulations that MMS will not use breach of a lessee's duty to market to dispute a lessee's marketing decisions, we still believe the potential for misapplication exists. This concern is not restricted simply to marketing decisions. As discussed at length in IPAMS' comments dated April 6, 1998, we believe there are many situations within the proposed rule that create the opportunity for MMS and its auditors to second guess a lessee's valuation determination as well.

Moreover, it is one thing to state in the regulations that the bureau will not second guess a lessee's marketing decisions; in practice, however, it may not be so easily accomplished. For instance, how will MMS determine that a lessee made his marketing decision "reasonably and in good faith"? What if the best price a lessee can obtain is considered by MMS to be "substantially below market value"? What if MMS's valuation guidance is later rescinded or negated? IPAMS' greatest concern is that the revised duty to market language could still be used to implicate a lessee who fails to secure the highest price obtainable. This is an arbitrary and subjective determination by MMS and one that gives IPAMS members considerable trepidation.

MMS is expanding the duty to market theory through its modification of the language in the regulations that would require lessees to place production in marketable condition and market for the mutual benefit of lessee and lessor *at no cost to the Federal lessor.* This is just another way that MMS is trying to capture the value of downstream prices without having to share in the costs and risks of obtaining those prices. The taxpayers will still benefit from those higher prices, but it is unfair to lessees to require them to bear 100 percent of the costs to move production to a better market, farther downstream, by terming it a marketing cost.

Exchanges

IPAMS is concerned that MMS still believes it must penalize those lessees that engage in a series of exchanges in order to sell their production, or in some cases, to access a more favorable market. It is grossly unfair to require a lessee to value his production at a NYMEX price because he has to exchange production more than once in order to effect the sale of his production, or because he is trying to obtain the best price he can get for his crude oil. It is incomprehensible to IPAMS why MMS will not permit a lessee to at least choose between comparable arm's-length benchmarks and NYMEX to value production that has been exchanged. MMS has failed to explain its rationale.

Furthermore, while it may often be difficult to trace a series of exchanges to the first arm's-length sale, lessees should still be given the option of doing so.

Gathering vs. transportation

IPAMS will defer detailed comment on this subject to the companies and trade associations that more frequently address offshore transportation issues.

Conclusion

MMS has requested that commentors refrain from reiterating previously filed comments. IPAMS wishes to honor that request. However, it must be emphasized again that IPAMS still has serious concerns with a number of outstanding issues that we will briefly enumerate here. We encourage you to refer to our earlier comments for further discussion on these issues.

- The imposition of NYMEX in the Rocky Mountain Area where a lessee is unable to meet the first two benchmarks.
- The concern that, because of the severe restrictions imposed, lessees will not be able to meet the first two benchmarks, thus forcing them to a NYMEX valuation.
- MMS's refusal to apply the same benchmarks nationwide and instead opt for a three-way system that will result in increased administrative burdens for both industry and MMS.
- The undesirable requirement to net back from a spot market and the attendant adjustments.
- MMS's refusal to provide binding valuation guidance.
- MMS's subjective determination of the value of transportation costs.
- MMS's treatment of noncompetitive crude oil calls.
- The requirement to submit the Form 4415.
- The overall administrative burden imposed by the regulations.

IPAMS is encouraged by the fact that meetings among the Interior Department, industry representatives and Members of Congress are occurring. We are hopeful that a reasonable and fair solution that is responsive to the needs of all parties can be developed through this process.

Again, IPAMS appreciates this opportunity to provide you with our comments. Please do not hesitate to contact me if you have any questions, or if you would like to discuss our comments in further detail.

Sincerely,

Carla J. Wilson
Director of Tax and Royalty